Fiscal Challenges Facing the New Member States

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- Fiscal situation of NMS at the day of EU accession
- Estimation of the fiscal costs of EU accession for NMS
- Prospects and conditions of meeting by NMS fiscal convergence criteria as defined by the Treaty of the European Union and SGP
- Long term fiscal challenges coming mostly from the unfavorable demographic trends, which face both OMS and NMS in a not so distant future
- Do the EU fiscal surveillance rules need in modification?
- Main findings and conclusions

Fiscal Legacy of Transition

Country	1999	2000	2001	2002	2003	2004 f	2005 f
Cyprus	-4.5	-2.4	-2.4	-4.6	-6.3	-4.6	-2.2
Czech Republic	-3.4	-4.5	-6.4	-6.4	-12.9	-5.9	-5.1
Estonia	-3.7	-0.3	0.3	1.8	2.6	0.7	0.0
Hungary	-5.6	-3.0	-4.4	-9.3	-5.9	-4.9	-4.3
Latvia	-4.9	-2.7	-1.6	-2.7	-1.8	-2.2	-2.0
Lithuania	-5.6	-2.6	-2.1	-1.6	-1.7	-2.8	-2.6
Malta	-7.6	-6.5	-6.4	-5.7	-9.7	-5.9	-4.5
Poland	-1.4	-1.8	-3.5	-3.6	-4.1	-6.0	-4.5
Slovakia	-6.4	-12.3	-6.0	-5.7	-3.6	-4.1	-3.9
Slovenia	-2.1	-3.0	-2.7	-1.9	-1.8	-1.7	-1.7
NMS *	-3.2	-3.0	-3.8	-4.7	-5.0	-	-

- \- aggregate across countries weighted using GDP converted at market exchange rates;
- Source: Eurostat (based on fiscal notifications), for 2004-2005 EC (2004)

Net Fiscal Effects of EU Transfers in 2004-2006 (% of GDP), annual average

Item	CZ	EE	HU	PL	SL	LT	LV	SK
Net fiscal effects of EU transfer flows	-0.1	1.0	-0.1	0.5	-0.0	1.6	1.8	0.3
Membership contribution	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Budgetary compensations	0.3	0.1	0.1	0.3	0.3	0.1	0.1	0.1
Structural Funds transfers	0.3	0.8	0.4	0.7	0.2	0.9	1.1	0.7
Cohesion Fund transfers	0.1	0.3	0.1	0.2	0.1	0.3	0.4	0.1
Internal actions and additional expend.	0.1	0.5	0.2	0.2	0.2	0.8	0.5	0.3
Rural development under the CAP	0.2	0.4	0.2	0.3	0.2	0.6	0.7	0.3

Source: EC (2002), AMECO database, own calculations

Accession Related Expenditures and Total Net Fiscal Effects of Accession in NMS-8 2004-2006 (% of GDP), annual average

Item	CZ	EE	HU	PL	SL	LT	LV	SK
Net fiscal effects of EU transfer flows (1)	-0.1	1.0	-0.1	0.5	-0.0	1.6	1.8	0.3
Accession related expenditures (2)	-2.5	-2.0	-1.5	-1.3	-1.3	-2.0	-2.0	-2.3
Infrastructure expenditures	-1.5	-1.5	-1.5	-1.5	-1.0	-1.5	-1.5	-1.5
Reform of publ. administ.	-1.5	-1.5	-1.0	-1.5	-1.0	-1.5	-1.5	-1.5
Phase-out of prod. subsidies	1.0	0.3	1.5	2.0	1.0	0.3	0.3	-0.3
Realignment of custom duties	-0.5	0.3	-0.5	-0.5	-0.5	0.3	0.3	-0.3
Tax harmonization	0.0	0.5	0.0	0.3	0.3	0.5	0.5	0.0
Total net fiscal effects of accession (1+2)	-2.6	-1.0	-1.6	-0.8	-1.3	-0.4	-0.3	-2.0

Source: EC (2002), AMECO database, Kopits and Szekely (2002), own calculations

NMS on the Road to EMU

Two fiscal convergence criteria can be the most difficult to be fulfilled for most of the NMS;

- fiscal deficit not exceeding 3% of GDP and
- public debt not exceeding 60% of GDP

An additional accession-related net fiscal burden can make this task even more difficult in the near future.

Negative Consequences for EU-25 of NMS Failure to Meet the Fiscal Criteria

1. Importance of fiscal prudence itself
2. Leaving NMS out of the Eurozone for a long time involves a risk of macroeconomic destabilization inside the European Union.
3. NMS will <u>not</u> be able to enjoy economic benefits of the Eurozone membership such as price stability, interest rate convergence, elimination of exchange rate risk and danger of currency crisis, decreasing transaction costs in intra-Union trade, etc.
4. Negative political consequences for the entire EU - two-class membership
5. Postponing by NMS their EMU entry for reason of their fiscal non-compliance will make meeting the convergence criteria at the later date even more difficult. Two reasons of such an adverse effect: (i) accumulation of additional public debt (or delay in its reduction); (ii) higher interest rates during the 'waiting' period.

Main assumptions of fiscal projection

Key Assumptions:

- debt to GDP ratio not higher than at starting date of the projection;
- improvement of primary balance – max. 1% of GDP annually
- max. fiscal surplus 2% of GDP
- no primary surplus after entering the EMU or reaching the target level of debt to GDP
- international interest rate 4%
- linear convergence of domestic interest rates ends 1 year before EMU accession

Four scenarios:

- Fast growth (5%), late accession (2012) scenario.
- Fast growth (5%), early accession (2007) scenario.
- Slow growth (2%), late accession (2012) scenario.
- Slow growth (2%), early accession (2007) scenario

FAST Growth, Comparison of Simulation Results (cumulatively in % of 2004 GDP)

Country	2012 EMU accession			2007 EMU accession			Differences		
	Primary surplus	Debt	Interest payments	Primary surplus	Debt	Interest payments	Primary surplus	Debt	Interest payments
Czech R.	2.2	23.2	7.8	6.0	18.1	6.5	-3.8	5.1	1.3
Hungary	17.7	71.5	32.6	19.8	58.5	23.2	-2.0	12.9	9.4
Latvia	3.1	19.8	7.4	5.4	15.5	5.8	-2.3	4.3	1.6
Poland	20.2	60.1	30.1	14.7	54.5	21.4	5.5	5.6	8.7
Slovakia	11.5	49.0	22.1	12.8	40.2	15.8	-1.3	8.7	6.3
Slovenia	12.9	35.4	17.3	12.2	29.1	11.9	0.7	6.3	5.4

SLOW Growth, Comparison of Simulation Results (cumulatively in % of 2004 GDP)

Country	2012 EMU accession			2007 EMU accession			Differences		
	Primary surplus	Debt	Interest payments	Primary surplus	Debt	Interest payments	Primary surplus	Debt	Interest payments
Czech R.	27.4	54.3	30.1	20.0	50.5	21.4	7.3	3.8	8.7
Hungary	6.0	19.5	7.4	6.7	18.0	6.6	-0.7	1.5	0.8
Latvia	19.2	41.1	21.1	15.2	38.7	15.6	4.1	2.4	5.5
Poland	29.2	59.8	31.1	23.3	56.3	22.9	6.0	3.5	8.3
Slovakia	18.6	29.7	16.5	14.0	28.0	11.7	4.6	1.8	4.9
Slovenia	6.3	16.6	7.0	6.2	15.1	5.7	0.2	1.5	1.3

The Long-term Fiscal Challenges in the EU-25/27

1. **Slow rates of economic growth**

- threatens especially OMS (many of NMS record a quite impressive GDP dynamics)
- the risk of slow growth rates can be potentially addressed through microeconomic reforms aiming to increase competitiveness of the European economy (what is the subject of the Lisbon agenda) and individual member states.

2. **Unfavorable demographic trends (population aging), particularly in NMS;**

- the declining fertility rates,
- increasing expected life horizon of the currently working generation,
- worsening a dependency ratio,
- increasing pension and health spending,

Unless adequately addressed on time the population aging may cause serious fiscal crisis in the next twenty or thirty years

Do EU Fiscal Surveillance Rules Need Modification?

Arguments against the EU fiscal discipline rules:

1. The upper limit of deficit of 3% of GDP does not leave room for an active counter-cyclical fiscal policy and does not allow the automatic fiscal stabilizers to work.
2. The 3% deficit limit neglects the public investment needs
3. Inconsistency between deficit and debt criterion. The debt-to-GDP level and its dynamics are more important than current deficit.

Counterarguments:

1. It disregards the SGP provision. If a country runs a fiscal surplus in 'good' times it will easily accommodate automatic fiscal deterioration connected with an economic downturn without breaching the 3% deficit limit. Plus a non-Keynesian effect of fiscal policy.
2. There are a lot of examples of mistargeted public investment programs. Danger of statistical manipulations.
3. True, but fiscal deficit is easier to be observed than public debt dynamics.

Steady State Debt Levels (as % of GDP)

Trend growth of real GDP in % p.a.	Cyclically adjusted deficit in % of GDP			
	2%	3%	4%	5%
Germany: 1.5%	57	86	114	143
OMS (?): 2%	50	75	100	125
Maastricht: 3%	40	**60**	80	100
NMS (?): 4%	33	50	67	83
NMS with Ballassa-Samuelson effect	29	43	57	71

Source: Gros (2004)

Enforcement problems:

- Technical problems with forecasting potential output and structural deficit
- Sanctions are not automatic
- High probability of ‘solidarity’ coalitions against rules enforcement

Main Findings and Conclusions

1. The EU member states should prepare themselves already today to meet the fiscal consequences of population aging the next decades.
2. The perspective of EMU entry should provide NMS a strong incentive to reduce deficit already now because postponing both fiscal adjustment and Euro adoption will only result in higher cumulative fiscal costs.
3. The additional fiscal burden connected with the EU accession cannot serve as excuse of delaying fiscal consolidation (it should pay off in a long-term perspective).
4. The EU fiscal surveillance rules should not become relaxed (but may be corrected giving priority to a long-term fiscal sustainability)
5. Any version of fiscal surveillance rules must be solidly anchored in the effective enforcement mechanism (automatic sanctions on Union level plus fiscal discipline rules on national level)